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March 14, 2006

## **AGENDA ITEM 6**

### **TO: MEMBERS OF THE FINANCE COMMITTEE**

- I. SUBJECT:** Request for Proposal: Board of Administration's Independent Financial Statement Auditor
- II. PROGRAM:** Audits
- III. RECOMMENDATION:** Staff requests the Finance Committee recommend to the Board of Administration approval of staff's recommendations for the issuance of a Request for Proposal to obtain the services of a qualified audit firm to audit CalPERS' financial statements beginning with Fiscal Year 2006/2007 and ending with Fiscal Year 2010/2011.
- IV. ANALYSIS:**

#### **BACKGROUND**

At the February 10, 2006 Finance Committee meeting, staff presented an agenda item for the procurement of the Board's Independent Financial Statement Auditor. The Finance Committee and staff recommended deferring the agenda item until the March 2006 meeting to address the issues raised during the last meeting and to revise the proposal at the direction of the Finance Committee. The primary issues of discussion focused on increasing the potential number of candidates that can respond to the Request for Proposal (RFP) and revising the proposed scoring methodology. The original agenda item presented at the February meeting is included as Attachment B showing the changes in the schedule of events and scoring methodology suggested by Committee members. Amendments to the agenda item are shown by strikeout font and new items added to the agenda are shown in underlined bold font. Before turning to the main RFP information, staff wishes to address the issues raised by the Finance Committee.

Increasing the number of participants responding to the RFP.

The Finance Committee inquired as to whether or not there were restrictions that would unnecessarily reduce the size of the pool of potential bidders for the Board's Financial Statement Auditor. The two restrictions discussed were:

- Government Code Section 20228 prohibits the Board's Auditor from serving two consecutive terms, and
- The Finance Committee Charter prohibits the Board's Financial Statement Auditor from performing consulting engagements for CalPERS.

Regarding the first restriction, prohibition of successive terms for the Board's Independent Financial Statement Auditor, the question becomes whether or not CalPERS could amend Government Code Section 20228 through legislation in time to be effective for this RFP. The deadline for all regular legislative bills was Friday, February 24, 2006. The criteria for urgency legislation, in general, require legislation that affects public peace, health, or safety. After consultation with Governmental Affairs Office, staff does not believe that this proposed legislation meets urgency criteria. Accordingly, staff does not believe that such legislation can be obtained in time for this RFP. However, staff will determine the feasibility of pursuing such legislation before issuing another RFP for an independent financial statement auditor.

Regarding the second restriction, the question becomes whether or not the Finance Committee Charter should be amended to allow the Board's financial statement auditor to perform consulting services for CalPERS. Staff believes that it will be helpful if we first look at the services the Board's Auditor is allowed to provide to CalPERS. The Finance Committee Charter, Attachment A, Section II, describes the allowed services, "In general, these services to be provided are those that are provided in the Statements of Auditing Standards and the Statements of Standards for Attestation Engagements promulgated by the Auditing Standards Board of the American Institute of Certified Public Accountants. The Finance Committee and the Board may make exceptions to these standards." Item 9 in the listing of allowed services reads, "Any other audit services approved by the Finance Committee and the Board that do not impair auditor independence." Therefore, the Board's Auditor is allowed to perform other attest services and agreed-upon-procedures for CalPERS and has performed such services in the past. The services which the Board's Auditor is prohibited from performing are consistent with Sarbanes-Oxley Act of 2002, and in addition, prohibit consulting services.

Staff believes that changing the prohibition of consulting for CalPERS by the Board's Auditor would not enlarge the pool of potential large CPA firms responding to the RFP. There are only four major accounting (audit) firms. Deloitte & Touche, LLP is prohibited from having two terms in succession. KPMG has a consulting contract with the Investment Office, Alternative

Investment Management (AIM) unit, and may bid on the renewal of their contract in a consulting pool. Five years ago, KPMG did not respond to the RFP for the Board's Auditor contract because of their work in AIM which KPMG felt was a conflict of interest. California State Law requires accounting firms to abide by standards for independence and objectivity issued by the American Institute of Certified Public Accountants (AICPA). These Professional Standards apply whether or not CalPERS has a consulting prohibition. Additionally, six years ago KPMG did not bid on the Board's Real Estate Compliance Auditor contract because they were already the auditor for two of CalPERS' General Partners, and they felt that the CalPERS work would be a conflict of interest. Currently, PricewaterhouseCoopers has completed its work on the risk management system for the Investment Office (system to be maintained by IBM), but PricewaterhouseCoopers is in the pool of firms performing real estate appraisals. Appraisal of real estate is valuation of assets, and this a prohibited activity per both the Finance Committee Charter and the Sarbanes Oxley Act of 2002. Therefore, CalPERS would have to manage properly the appraisal work to avoid a potential conflict of interest, allowing them to respond to the RFP. Ernst & Young is not performing consulting for CalPERS at this time. At this point, if the Finance Committee wishes to modify the prohibition of consulting for CalPERS by the Board's Auditor, it would require amending the Finance Committee Charter. If the Finance Committee desires to pursue an analysis of this issue, staff could prepare an agenda item for the Finance Committee at a later date.

Text from the Prior RFP Agenda Item, Modified for the Date Changes and In Response to Suggestions from Committee Members.

Section 20228 of the Government Code requires the Board of Administration to annually employ a Certified Public Accountant to audit CalPERS' financial statements. This law limits the engagement of the Certified Public Accountant to a maximum of five years. The five-year term of the current Board's auditor, Deloitte & Touche, LLP, will expire with the conclusion of the 2005-2006 financial statement audit. Therefore, this RFP begins the procurement process for an independent financial statement auditor for 2006-2007 financial statements and the financial statements of the following four fiscal years.

The Finance Committee's responsibilities in procuring and overseeing the services of the financial statement auditor are described in the Finance Committee Charter. This agenda item has been prepared by staff to aid the Finance Committee in this process as required by both the Finance Committee Charter and the Office of Audit Services Charter. Specifically, the Finance Committee Charter has the following passage:

**“B. Independent External Financial Statement Auditor**

1. To review the responses received to solicitations sent to auditing firms and to recommend the selection of the independent auditors to be engaged by the Board. This process occurs every five years under Government Code, Section 20228, which states that an auditor may not serve two consecutive terms.”

**DISCUSSION**

The Request for Proposal is designed to solicit qualified Certified Public Accounting firms to competitively bid for engagement as the Board’s independent financial statement auditor. The proposal envisions awarding a contract to the successful bidder to audit for five successive fiscal years from 2006/07 through 2010/2011. However, the actual term of the contract is for 5 and one-quarter (5-1/4) years to allow for transition from one auditor to the next. This is necessary because the audit of a fiscal year, such as 2004/2005, is performed during the period July through October of the following fiscal year, and the reports may be presented to the Finance Committee during November, December and February of this same following fiscal year. *Therefore, staff recommends that contract duration be extended to 5-1/4 years, which is beyond the Board’s policy of 5 years.*

In the Year 2000, the last Request for Proposal attracted only two qualified bidders. While these two bidders were highly qualified firms, there remained the question of whether the Board was receiving the services at a reasonable cost given the absence of additional bidders. To address this issue, staff analyzed the last Request for Proposal process and modified the Request for Proposal to broaden the ability for more Certified Public Accounting firms to bid on the engagement. Staff believes that we can attract a wider range of bidders by modifying the Minimum Qualifications without significantly reducing the audit quality obtained. A summary of modifications to the Minimum Qualifications in this Request for Proposal is presented in Attachment A. The major changes since the last Finance Committee review of independent auditor responsibilities are discussed briefly as follows.

*Joint Venture Policy Variance.* With the last Request for Proposal, a significant barrier to potential bidders was the requirement that a primary bidder lacking expertise in an area had to form a joint venture with another firm in order for the other firm’s expertise to be allowable for meeting Minimum Qualifications per CalPERS’ Joint Venture Policy (mix and match their individual experience and qualifications for meeting the Minimum Qualifications). Consequently, smaller audit firms would have to obtain actuarial expertise through a joint venture with an actuarial firm to meet two Minimum Qualifications of the last Request for Proposal. Actuarial firms were then and still are not willing to enter into joint ventures for this purpose. Therefore, we propose allowing the primary firm to

subcontract for needed actuarial expertise as required. Staff believes this change is necessary because many audit firms do not have in-house actuaries. After consultation with the Legal Office, the staff of the Office of Audit Services recommends a variance from the Joint Venture Policy. *Staff recommends permitting cumulating experience and qualifications between partnering firms without forming joint ventures for actuarial services as specifically described in the Minimum Qualifications of Attachment A, Items 1 and 4 of this Agenda Item. Experience for Key Personnel and Firm Experience in Auditing Classes of Investments.* In order to increase the potential number of bidders, staff has established the minimum number of years of experience required for each Minimum Qualification for the key personnel, as outlined in the Minimum Qualifications, Attachment A, Items 9, 10, and 11. We believe that persons meeting these qualifications will be able to provide a sufficient quality of services to CalPERS. *Staff recommends approval Items 9, 10, and 11 in the Minimum Qualifications, Attachment A.*

Staff believes that audit experience with different types of investment vehicles is necessary, but staff recommends changing the threshold of prior audit experience for each investment vehicle as outlined in Attachment A, Item 3. Staff believes that this change is prudent. In addition, the other Minimum Qualifications are outlined in Items 2, 5, 6, 7, 8, 12, 13, and 14 in Attachment A. *Staff recommends approval of the remaining Minimum Qualifications, 2, 3, 5, 6, 7, 8, 12, 13, and 14, listed in Attachment A.*

Schedule. The proposed schedule for the RFP process is shown below.

### **PROPOSED SCHEDULE OF EVENTS**

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RFP Release Date	March 20, 2006
Deadline to Submit Written Technical Questions	April 17, 2006, 1:00 p.m. PST
Mail Response to Written Questions	April 27, 2006
Final Filing Date	May 31, 2006 at 3:00 p.m. PST
Preliminary Review*	June 1, 2006 through June 5, 2006
Evaluation of Proposals*	June 6, 2006 through June 9, 2006
On-site Visits (Optional)	TBD
Finalists Selected and Notified*	June 12, 2006
Finalists Interviews* (time to be determined) Finance Committee Meeting	August TBD, 2006

Post Notice of Intent to Award*	TBD
CalPERS Anticipated Contract Performance Start Date*	January 1, 2007

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\* All dates after the Final Filing Date are tentative and are subject to change by CalPERS upon written notification to all Proposers.

The proposed date of release of the RFP is Monday, March 20, 2006. The RFP process includes a final filing date of May 31, 2006. The Finance Committee will interview and score the finalists at an August TBD, 2006 meeting in order to give the successful bidder time to prepare to begin the contract on January 1, 2007. This will require a special August meeting of the Finance Committee. The Finance Committee will recommend to the Board of Administration the selection of CalPERS' independent financial statement auditor, consistent with the Finance Committee Charter. *Staff recommends approval of the proposed schedule of events and an additional meeting of the Finance Committee on August TBD, 2006, to hear the finalists' proposals.*

Scoring. The scoring for the RFP will be as follows.

Technical Proposal.....	200 points
Fee Proposal.....	100 points
Finance Committee .....	<u>200 points</u>
Total.....	<u>500 points</u>

The Finance Committee scoring will be conducted according to CalPERS' policy as described below.

Upon completion of the interview process, the Finance Committee will rank Finalists by motion. Irrespective of the number of bidders, the highest ranked Finalist will receive 200 points, the second highest will receive 150 points, the third highest 100 points and the fourth highest 50 points. Each Finalist's score will be combined with its Technical and Fee Proposals scores, as prescribed on the Proposal "Evaluation Sheet." This mechanism of scoring requires an exemption from CalPERS policy, and this mechanism is desirable because only a very few bidders are expected to be finalists.

*Staff recommends approval of the scoring as described above, including a variance from policy for scoring the finalists as described. The fee proposal will constitute 20% of the total, which is less than the general guideline of the Department of General Services, but which staff is comfortable recommending given the importance of non-quantitative factors in the selection process.*

Staff believes that this RFP will result in an improved process to obtain bids for and selection of the next CalPERS' independent financial statement auditor.

Summary of Recommendations. Staff seeks Finance Committee approval and recommendation to the Board of Administration for issuance of a Request for Proposal, which includes the following provisions:

- Proposed schedule of events, including an August TBD meeting,
- Minimum Qualifications as proposed in Attachment A,
- Scoring as described, with two variances from policies,
- Exemption from CalPERS' Joint Venture Policy, and
- Contract duration of five and one-quarter (5-1/4) years.

**V. STRATEGIC PLAN:**

This item is not a specific product of the Strategic Plan, but assists the Board of Administration in fulfilling its fiduciary role and statutory responsibility to secure an annual independent financial statement audit. This fiduciary role and statutory responsibility reside with the Finance Committee per the Finance Committee Charter.

**VI. RESULTS/COSTS:**

This item will result in solicitation of Certified Public Accounting firms to competitively bid on a five-year engagement as the Board of Administration's independent financial statement auditor. The costs will be determined by the cost proposal of the successful bidder.

Staff is available to answer questions of the Finance Committee Members.

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Larry Jensen, Chief  
Office of Audit Services

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Peter H. Mixon  
General Counsel

Attachments